5/26/87 PS650-2

JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

NO. 19B
May 15, 1987

IN THIS ISSUE:

Japanese Purchases Of U.S. Securities Remain Strong 1

Finance Committee Completes Action On Trade Bill 4

Quotas On Textiles, Apparel, Footwear: Winners And Losers 5

Extra Diet Session Seen Likely 7

Japan-EC Relations Reflect U.S. Tensions 8

Agricultural Issues: The Next Big Bilateral Showdown? 11

Notes: Second KDD 12

Japanese Purchases Of U.S. Securities Remain Strong

Despite the recent volatility of exchange rates, Japanese investors were large purchasers of U.S. Treasury bonds in the May 5-7 $29.05 billion refunding operation. The Japanese reportedly bought nearly half of the $9.27 billion in 30-year bonds offered and about one-fourth of the total amount auctioned. Nevertheless, yields were about 1.25 percentage points higher than in the February auction, reaching 8.76 percent on 30-year bonds.

Since many Japanese buyers have lost money on U.S. bond investments as a result of the plunge in the dollar's value, some financial analysts expected them to reduce their purchases last week out of concern that the dollar would

continue to fall. The Yomiuri Shimbun estimates that Japn's seven major life insurance companies had foreign exchange losses of $10.2 billion in FY 1986 (April 1, 1986-March 31, 1987), although these losses have been partly offset by capital gains resulting from the strong bond market. The dollar's current weakness, though, may mean that its long slide is finally over. Some economists believe the dollar is already undervalued, given its weak purchasing power relative to other currencies. According to Samuel D. Kahan of Chicago's Kleinwort Banson Government Securities, the dollar is undervalued by 35 percent against the yen based on consumer prices in the two countries.

Japanese purchases were also boosted by the rise in the gap between long-term interest rates in the two countries. The differential, which had fallen to under 3 percentage points at the beginning of the year, is now about 5 percentage points. U.S. interest rates have risen in response to worries about higher inflation and the Federal Reserve Board's tighter monetary policy (see JEI Report No. 18B, May 8, 1987). At the same time, the Bank of Japan, which lowered its official discount rate to a record-low 2.5 percent in February, has taken steps to reduce Japanese interest rates. While the central bank is denying rumors of a further cut in the discount rate, it is lowering short-term interest rates by pumping money into the financial system. Last week it purchased Y700 billion ($5 billion at Y140=$1.00) worth of commercial bills and certificates of deposit.

Japanese capital has played a key role in the world economy during the past few years, as net purchases of foreign bonds surged from only $6.1 billion in 1982 to $93 billion last year (see Table 1). The increase reflects a variety of factors including the country's high saving rate. With household savings too large to be fully utilized by domestic industry and the government intent on shrinking its budget deficits, the surplus has been invested abroad (see JEI Report No. 17A, May 1, 1987).

Financial liberalization has also prompted increased capital flows. Prior to April 1986, for example, trust banks and life insurance companies, which are major purchasers of foreign securities (see Table 2), were only allowed to invest a maximum of 10 percent of their total funds in foreign assets. That ceiling is now 30 percent. Financial liberalization has also encouraged the globalization of financial markets. As of July 1986, for example, Japanese securities firms operated 150 offices in foreign countries, while banks had 74 foreign subsidiaries and 196 branch offices overseas helping to invest Japanese funds abroad.

A significant share of Japan's foreign investment has been in the U.S. bond market. According to the central bank, net purchases of U.S. securities (including government and corporate bonds) totaled $31.6 billion in 1985. While official data are not yet available, The Economist estimates that the amount doubled in 1986, attracted by high interest rates, political stability and market depth. The global U.S. dollar bond market, for example, is more than four times as large as the market for bonds denominated in Deutsche marks.

Japan's long-term capital flows are likely to remain significant even as its trade surplus begins to decline. Given its status as the world's largest creditor nation, Japan's investment income from abroad will rise substantially, boosting its current account surplus.

Table 1: Japan's Long-Term Capital Flows, 1982-86

(in billions of dollars)

	1982	1983	1984	1985	1986
Gross outflows	$27.4	$32.5	$56.8	$81.8	$132.1
Direct investments	4.5	3.6	6.0	6.5	14.5
Trade credits	3.2	2.6	4.9	2.8	1.8
Loans extended	7.9	8.4	11.9	10.4	9.3
Equities	0.2	0.7	0.1	1.0	7.0
Bonds	6.1	12.5	26.8	53.5	93.0
Other	5.5	4.7	7.1	7.6	6.4
Gross inflows	12.4	14.8	7.1	17.3	0.6
Net outflows	15.0	17.7	49.7	64.5	131.5

Source: Bank of Japan

Table 2: Japanese Holdings of Foreign Securities, As of December 1986

(in billions of dollars*)

Type of Institution	Total Assets	All Securities	Foreign Securities	Percent of Total Securities
Life insurance companies	$386	$156	$45.1	28.9%
Trust accounts	701	224	38.3	17.1
Nationwide banks	1,360	162	21.9	13.5
Regional banks	717	134	15.6	11.6
Trust banks' banking accounts	222	56	10.8	19.3
Long-term credit banks	301	62	10.4	16.8
Postal life insurance system	179	99	9.0	9.1
Other insurance companies	87	39	8.5	21.8
Total	3,953	932	159.6	17.1

*Converted into dollars at December 1986's average exchange rate of Y162.13=$1.00.

Source: Bank of Japan

It is likely, though, that there will be a modest diversification away from U.S. bonds. Some analysts have noted increased Japanese investment in Canadian dollar and Australian dollar bonds. Diversification will also take the form of increased purchases of U.S. equities and direct foreign investment in this country. Attracted by price/earnings ratios significantly below those in Tokyo, Japanese net purchases of U.S. stocks jumped from less than $1 billion in 1985 to an estimated $5 billion in 1986. Purchases of U.S. commercial real estate showed a similar increase last year.

Randall S. Jones

Finance Committee Completes Action On Trade Bill

On May 7 the Senate Finance Committee overwhelmingly approved S 490, its counterpart to the House omnibus trade bill. The consensus shown by the 19-1 vote reflects approval for the process rather than for the provisions of the bill, however. Ranking minority member Robert Packwood (R, Ore.) voted for S 490, but reportedly recommended that the White House veto it if the Senate and the eventual House-Senate conference committee do not moderate the legislation.

Despite the reservations of Sen. Packwood and other Republican members, the near-unanimity of the vote can be counted as a victory for committee chairman Lloyd Bentsen (D, Tex.). The markup process was an exercise in bipartisan compromise, resulting in several modifications of the original proposal. Many observers agree that Mr. Bentsen's emphasis on consensus-building was instrumental in developing broad support for passage of a trade bill, if not the specific provisions of S 490. Hence, some GOP legislators voted "yes" for a bill they do not presently support.

On the question of mandatory retaliation, the bipartisan spirit was at a peak. A compromise offered by Sen. Packwood sailed through the committee. It called for mandatory retaliation in response to a positive determination under Section 301 of the 1974 Trade Act only when unfair foreign trade practices violate a trade agreement. The president could choose not to retaliate in four instances: (1) if the General Agreement on Tariffs and Trade rules against the United States; (2) if an agreement is reached that is acceptable to the majority of the industry or the petitioner; (3) if retaliation would cause serious harm to national security; or (4) as a last resort, if the U.S. Trade Representative certifies that it would be impossible for the country to eliminate the practice and full compensation was provided.

In other areas a compromise was more elusive. Consequently, the committee adopted some provisions that GOP lawmakers and the White House found objectionable. For instance, the committee amended Section 201 of the 1974 Trade Act to require the president to provide relief to import-affected industries in certain circumstances. Given the administration's consistent arguments about the need for flexibility, its resistance to this provision was not surprising. Even with regard to issues on which there was no consensus, though, the debate was never completely partisan. Trade-conscious Republicans, especially John Heinz (R, Pa.) and John Danforth (R, Mo.), adopted, for the most part, positions as tough as the Democrats or even tougher.

In addition, the importance of the supplemental budget has grown in the face of difficulties brought on by the strong yen. Both domestic and international groups are urging prompt adoption of a stimulative budget to offset the negative impact of the yen and create additional demand for imports. Furthermore, Diet action would be required should the tax panel reach a compromise on a reform of the country's tax code.

Interwoven in these questions are political issues as well, principally the question of Yasuhiro Nakasone's tenure as president of the ruling Liberal Democratic Party and prime minister. Nakasone opponents view talk of extending the current session or calling an extraordinary session as a ploy to keep the prime minister in office despite pressure to resign before his presidential term expires in October. A call for an extraordinary session or an extension of the present session would mean that the Diet would probably be in session throughout the summer, thus justifying Mr. Nakasone's remaining in office through the rest of his term.

The dates most frequently proposed for an extraordinary session are either in June, following the Venice summit, or early August. Nakasone supporters favor the earlier scenario; opponents prefer a later starting date to maintain pressure on him to resign after the June summit. In substantive terms there is little difference between the legal domain implied by an extraordinary session or an extension of the present session, thus suggesting that the timing is more a political than a legal issue. Although a later starting date would give policymakers more time to resolve outstanding issues, extending the current session would eliminate the need to reintroduce measures currently pending.

The fact that Mr. Nakasone apparently favors an early session indicates his determination to remain in office at least through the remainder of his term, despite rumors in the press that the Venice summit will serve as his swan song. There was considerable speculation in the Japanese press in April that the prime minister would resign after his trip to the United States, particularly if it was judged a failure in Japan. While Mr. Nakasone admitted that the sessions with President Reagan did not completely alleviate the trade tensions between the two countries, the overall impression left by his Washington stay was not negative (see JEI Report No. 18B, May 8, 1987). At the very least observers are willing to give the prime minister an "A" for effort since the reaction in Japan to the talks was mild in comparison to the excitement leading up to the visit.

Michael W. Chinworth

Japan-EC Relations Reflect U.S. Tensions

With its hands already full trying to deal with U.S.-Japan economic relations, Tokyo is coming under pressure from the European Community to simultaneously address some contentious trade issues. EC officials are concerned that the community will suffer from recent U.S.-Japan trade agreements, in particular last year's semiconductor accord. In addition they are worried that Tokyo's lavish attention to relations with the United States will leave it little time to devote to continental affairs. Several EC proposals, however,

are as unprecedented as the U.S. imposition of 100 percent tariffs on particular Japanese exports.

According to Ministry of Finance statistics, Japan's 1986 trade surplus with the EC increased almost 7 percent to Y2.8 trillion ($20.2 billion at Y140=$1.00) as exports rose 8.5 percent to Y5.2 trillion ($37 billion) and imports jumped 10.4 percent to Y2.4 trillion ($16.8 billion). Because the yen has appreciated 88 percent against the dollar since its February 1985 low but has only climbed about 9 percent vis-a-vis the European Currency Unit, authorities fear that Japanese exports to the continent will surge to compensate for lost profits in the American marketplace. Although the EC and Japan already monitor trade in a handful of major products, Washington's imposition of retaliatory tariffs on Japanese exports of 18- to 20-inch color televisions, certain power tools and 16-bit portable and desk-top computers sparked a reaction from Brussels: these same items were put under surveillance on May 6. European importers are now required to obtain import licenses for these items from the respective national authorities, but only so that accurate statistics can be compiled. Should imports of these products surge, EC Commissioner for External Trade Willy de Clerque warned, the community would consider imposing punitive tariffs.

The EC Commission is also considering pressing Tokyo for wider access to Japanese financial markets. This is of particular interest to British and West German authorities since Japanese institutions have been allowed to gain significant positions in their home markets. British ire over Tokyo's refusal to allow British banks greater freedom in Japan boiled over briefly in late April. Prime Minister Margaret Thatcher threatened to bar all Japanese companies from British financial markets under the authority of new reciprocity legislation unless British firms were granted more seats on the Tokyo Stock Exchange. Although London reconsidered the threat when it realized that the move would backfire, the fact that the government even considered such a move suggests the intense pressure that domestic interests are putting on European administrations.

In a related move, the EC is investigating the alleged dumping of dot matrix and daisywheel printers by Japanese firms. Japanese makers controlled nearly 75 percent of the European market for these computer peripherals in 1986, with combined sales of nearly 1.7 million units, while domestic makers' saw their share fall to only 7.5 percent. Europrint, a manufacturers association, accused Japanese exporters of dumping at margins of 40 percent on dot matrix and 50 percent on daisywheel printers. In addition, continental photocopying equipment concerns, having lobbied the EC to impose a 20 percent tariff on imports of Japanese copiers, are now anxious to extend the levies to copier parts in an effort to cripple "screwdriver" assembly plants set up by Japanese copier makers trying to avoid the duties. Despite strong support for the tariffs by some British firms, London is opposed to extending the duties because it may dampen Japanese investment in local plants.

At an April 30 meeting between Mr. de Clerque and Tetsuo Kondo, director general of the Economic Planning Agency, Mr. Kondo outlined the details of the second Maekawa report (see JEI Report No. 17B, May 1, 1987) and said that it would lead to reduced trade frictions with Japan's trading partners. Mr. de Clerque was not impressed and asked for immediate relief, including reductions in Japan's liquor tax. On May 11 Tokyo responded to another European

request, announcing a May 14 seminar for European companies interested in bidding on construction contracts for the terminal facilities of the Kansai International Airport. Efforts to promote EC exports will take another step forward on June 1-5 when an EC official will travel to Japan for talks on cars, medical equipment and cosmetics. In addition, the EC delegation in Japan hopes to inaugurate a link with the Oita prefectural authorities to promote imports.

Jon Choy

Japan's Trade with the European Community, 1985-86

(in millions of yen and percent change)

	1985		1986	
	Exports	Imports	Exports	Imports
United Kingdom	Y1,131,670	Y432,424	Y1,122,837	Y593,175
	2.3%	-9.3%	-0.8%	37.2%
West Germany	1,646,278	699,831	1,766,215	725,473
	4.9%	10.1%	7.3%	3.7%
France	495,646	316,740	532,237	311,671
	8.2%	8.1%	7.4%	-1.6%
Italy	265,350	252,011	290,424	250,820
	8.4%	1.3%	9.4%	-0.5%
Netherlands	490,555	105,210	549,044	97,356
	14.1%	2.5%	11.9%	-7.5%
Belgium	349,225	116,082	371,628	113,847
	10.1%	4.5%	6.4%	-1.9%
Denmark	181,952	138,413	167,117	131,250
	-18.7%	-33.9%	-8.2%	-5.2%
Ireland	61,273	50,068	52,318	46,924
	4.3%	-11.5%	-14.6%	-6.3%
Luxembourg	3,745	444	3,954	420
	58.0%	178.9%	5.6%	-5.4%
Greece	142,309	15,671	94,271	12,433
	-23.4%	-10.8%	-33.8%	-20.7%
Portugal*	(41,176)	(13,172)	43,392	14,109
	14.8%	-21.9%	5.4%	7.1%
Spain*	(143,303)	(83,660)	180,282	50,804
	14.7%	-15.4%	25.8%	-39.3%
Total	4,768,004	2,126,894	5,173,719	2,348,282
	3.7%	-3.8%	8.5%	10.4%

*Not included in 1985 figures because they joined the EC in January 1986.

Source: Japan Tariff Association, Summary Report: Trade of Japan.